SECTION IV

LIHTC ALLOCATION BASICS

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The following section highlights some of the statutory and regulatory provisions directly affecting project compliance. The following is not meant as an exhaustive listing of compliance regulations and presents only a generalized description of the topics. Owners / managers of LIHTC projects should contact a professional for detailed description of these topics for their project.

Part 400 What is the Low Income Housing Tax Credit (LIHTC)?

The LIHTC is a dollar for dollar reduction in the tax bill of the owner's (or investor's) tax bill. In exchange for the tax credit, the owner agrees to rent a percentage (or all) of the units in a development to low income persons and restrict rent amounts. See Section II (Overview of the LIHTC Program) for further discussion of the tax credit.

Part 405 Eligible Basis

Eligible basis is tied to the credits that can be claimed. It consists of the cost of new construction; the cost of rehabilitation and / or the cost of acquisition of buildings to be converted to low-income housing. It equals all eligible areas of the project inclusive of LIHTC units, common areas, hallways, elevators, doors, windows, rooftops, parking lots, management offices, etc. Only the adjusted basis of the depreciable property may be included in the eligible basis. The cost of land, which is non-depreciable, is not included in adjusted basis.

Eligible basis does not include commercial space. Projects in which only a portion of the buildings are used for residential purposes and in which part is commercial space (or other non-eligible space, such as congregate care, dormitory, etc.) are termed "mixed-use" projects. See Part 960 (Commercial Space) for more information about mixed-use projects and commercial space.

For a discussion related to eligible basis, See Part 420 (Qualified Basis).

Part 410 Minimum LIHTC Set-Aside

In exchange for the tax credits, federal regulations mandate that an owner of an LIHTC project maintain at least the minimum required number of LIHTC units in order for any building in the project to be eligible to claim tax credits. The minimum set aside, also referred to as the "project set aside" is the minimum percentage of units an owner commits to reserving for tax credit eligible households paying a restricted rent. By the time credit is allocated, the owner has selected one of the following two minimum set-aside elections on a project basis:

A. At least 20% of available rental units must be rented to households with incomes not exceeding 50% of area median income adjusted for family size

or

B. At least 40% of available rental units must be rented to households with incomes not exceeding 60% of area median income adjusted for family size.

Two examples are as follows:

Michigan Villas is a 75-unit project. If the owner elects the 20% @ 50% minimum set-side, then at least 15 of the 75 units must be occupied by persons at 50% of median or below.

Great Lakes Apartments is a 75-unit project. If the owner elects the 40% @ 60% set-aside, a minimum of 30 of the 75 units must be occupied by persons at 60% of AMGI or below.

Other pertinent information regarding the minimum set-aside are as follows:

- The minimum set-aside must be met on a project-wide basis (26 CRF Part 1, Public Comment).

- Once the owner has committed to a set-aside, it is irrevocable. The minimum set-aside is selected at the time of LIHTC allocation and then again designated on the IRS 8609.

- An owner cannot take any tax credits until the property meets the set-aside requirement. For more information on claiming the LIHTC, see Part 445 (First Year of the Credit Period) and Part 450 (Claiming the LIHTC Credit in Years Two through Ten).

- The minimum election of 60% or 50% AMGI affects all low-income units within a project. If the project falls below the minimum threshold limit, it is no longer considered a qualified project and is no longer eligible for credit. In addition, there is a possibility of recapture of credit claimed in earlier years, as well as other penalties.

- The minimum set-aside is always calculated as a percentage of units. It is never based on a percentage of square feet at the property.

- The minimum set-aside is referred to by several different names / terminology. The minimum set-aside election is sometimes called the 40/60 or 20/50 election or test. It is also known as the project set-aside.

- Since tax credits are only available for project costs associated with the low-income units and not for market-rate units, some owners elect to maintain more than the minimum required number of units in the project as low-income. In other words, some projects elect an applicable fraction of greater than the 20% or 40% minimum requirement. See Part 415 (Applicable Fraction) for a discussion of the applicable fraction.

For more information, see IRS Revenue Ruling 90-89 (Minimum Set-Aside Requirements), which is discussed in Appendix H. See Section V (Income Limits, Rent Limits, and Utility Allowances) for a discussion about targeting requirements.

Part 415 Applicable Fraction

The applicable fraction represents the portion (percentage) of the building for which tax credits will be claimed. The applicable fraction is the lesser of the total number of tax credit units divided by the total number of residential units in the project or the total square footage of tax credit units divided by the square footage of total units. For example,

> *A building in Michigan Villas has 25 residential units, consisting of 13 two-bedroom units and 12 one-bedroom units. Each two-bedroom units contains 800 square feet and each one-bedroom unit contains 600 square feet. The total square footage of the building is 16,950. Of the 25 residential units, 16 units (consisting of 10 one-bedroom and 6 two-bedroom units) are reserved for low income households. The percentage of units reserved for low income persons is 64% (16/25). The percentage of square feet reserved for low income is 61.36% (10,800 / 17,600). The applicable fraction of the building is therefore 61.36%, which is the lesser of the low income unit percentage versus the square footage percentage.*

Other pertinent information regarding the applicable fraction is as follows:

- The term "unit fraction" is sometimes used when discussing the ratio of low-income units to total housing units in a building. The term "floor space fraction" is sometimes used when discussing the ratio of the floor area of the low-income units to the floor area of all housing units. The applicable fraction of a building is the lesser of the Unit Fraction and the Floor Space Fraction.

- The applicable fraction must be met on a building-by-building basis. Different buildings within a project can sometimes have different applicable fractions.

- Projects in which all of the units are reserved for low-income persons have a 100% applicable fraction. Projects in which only a portion of the units are reserved for low-income persons (and thus have an applicable fraction of less than 100%) are called "mixed income" projects. See Part 905 (Mixed Income Projects) for more information on mixed income projects. See Part 910 (Deeper Targeting / Agency Covenants) for discussion about a related topic.

Part 420 Qualified Basis

Eligible basis equals all eligible areas of the project inclusive of LIHTC units, common areas, hallways, elevators, doors, windows, rooftops, parking lots, management offices, etc. Qualified basis is equal to the number of LIHTC units only. The qualified basis of a qualified low-income building for any taxable year is an amount equal to the applicable fraction (determined as, at the close of the taxable year) of the eligible basis of each building.

For a related discussion, see Part 405 (Eligible Basis).

Part 425 The Annual Tax Credit Amount

The maximum amount of credit that can be allocated is calculated by multiplying the "eligible basis" by an "applicable fraction" to ascertain the "qualified basis" and then multipling by the "applicable credit percentage."

QUALIFIED BASIS = Eligible Basis X Applicable Project fraction
ANNUAL TAX CREDT $$$ AMOUNT = Qualified Basis X Applicable Credit Percentage

The applicable credit percentage is determined based on a formula using federal interest rates and present value annuity factors. The applicable credit percentage should not be confused with the applicable fraction. The annual tax credit dollar amount can be claimed each year for ten years. For additional information, see Part 440 (Credit Period).

Part 430 Allocation and Year of the Credit

The year of the credit is the year that credit was allocated. For most projects, the year of the credit is the date a carryover allocation was issued and is not necessarily the year of the IRS 8609. The year is significant because of certain LIHTC requirements and the terms of the credit period and compliance period are dependent on the year that the credit was allocated. The first two digits of the building identification number indicate the year of the credit. See Part 970 (Building Identification Numbers) and Part 235 (IRS 8609 Form) for more information.

Part 435 Placing an LIHTC Building in Service

IRS Notice 88-116 states that the term "placed in service" has two definitions – one for buildings and one for rehabilitation expenditures that are treated as a separate new building. The placed-in-service date for a new or existing building is the date on which the building is ready and available for its specifically assigned function, i.e. the date on which the first unit in the building is certified as being suitable for occupancy. In general, a transfer of the building (i.e. acquisition) results in a new placed-in-service date on the date of the transfer, the building is occupied or becomes ready for occupancy, whichever is later. Under Section 42(e)(4)(A) of the IRC, rehabilitation expenditures that are treated as a separate new building are placed in service at the close of any 24 month period over which such expenditures are aggregated.

The placed-in-service date is the date that the building became available for occupancy (i.e. the date a certificate of occupancy was issued and effective). This date may be different for each building in the project.

To obtain a copy of IRS Notice 88-116 see Appendix H.

Part 440 Credit Period

Once allocated by the housing credit agency, tax credits can be claimed annually over a ten (10) year period. The ten-year period over which an owner may claim tax credits usually begins by the end of the taxable year that a building is placed in service. Alternatively, an owner may elect to defer the beginning of the ten-year credit period to the next taxable year.

Part 445 First Year of the Credit Period

A. Claiming Tax Credits in the Initial Year

The credit is claimed annually for ten years and the credit period can begin in the year that the building is placed in service. During the first year of the credit period, the low-income occupancy percentage is calculated on a monthly basis. The calculation begins with the first month in which the project was placed in service (or the following year if there is an election to defer the credit period) even though the building may not be occupied during that month. Occupancy for each month is determined on the last day of the month.

An IRS Form 8609 is completed for each building in the development receiving tax credits and is filed with the taxpayer's return for the first year of the credit period. Owners can elect to defer the start of the credit period by checking the appropriate box on the IRS Form 8609. A sample copy of this form and its instructions are located in Appendix I.

B. Initial Year Proportion

A project claiming credit in the initial year of occupancy is subject to a special provision limiting the credit to a proportionate amount based on average occupancy during the year. For example:

If one-half of the low-income units were occupied in November and the remaining one-half were occupied in December, the building would be treated as being in service for 1.5/12 (12.5% - all of December and half for November) of the year for a calendar year partnership. In the 11th year, the disallowed credit of 10.5/12 (87.5%) could be claimed.

If a qualified Low income tenant becomes an ineligible tenant prior to the end of the initial tax credit year, that unit cannot be counted in the first year toward the minimum set-aside for purposes of determining the qualified basis.

For additional perspective, see the IRS Memorandum "Low Income Housing Credit: Clarification of 42(l)(1), certification with Respect to 1st Year of Credit Period", which is included in Appendix N.

Part 450 — Claiming the LIHTC in Years Two Through Ten

Owners must file an IRS Form 8609 (Low Income Housing Credit) with the Internal Revenue Service for every year of the ten-year period. This form is a certification by the owner that the LIHTC projects have been in continuing compliance and the qualified basis of the development for each year of the credit period. IRS Form 8586 must be attached to IRS Form 8609 and Schedule A (IRS Form 8609) and submitted annually with the owner's federal tax return. A sample copy of this form is located in Appendix I.

Part 455 — Units that Have Never Been Occupied by Qualified Residents

Units that have never been occupied cannot be counted as "low-income", but must be included in the "total units" figure for purposes of determining the applicable percentage. The transfer of existing tenants to never-occupied units cannot be conducted for purposes of meeting the minimum set-aside or applicable fraction in the first credit year of the project.

Part 460 — The Two-Thirds (2/3) Rule

If a tax credit unit has not been occupied by the end of the first year of the credit period, tax credits cannot be claimed on that never-occupied unit in that year. Should the unit become occupied after the end of the first year of the credit period, two-thirds of the credit can be claimed each year for the remaining years of the 15-year compliance period. In other words, 14 years of 2/3 of the credit amount allocated for that unit can be claimed. Thus, 1/3 of one year's worth of credit will be permanently lost. A simplistic example is as follows:

A 100-unit project with a 100% applicable fraction has an annual credit allocation of $500,000. In theory, each of the 100 units is "worth" $5,000 per year in tax credits, which is $50,000 total over the ten year credit period. The total amount of credit available for the 100 unit project is $5,000,000 over a ten year period.

During the first year the building is placed in service, only 99 of the 100 units are leased. Even though the applicable fraction was not met, the owner elects to claim credits for that year for the 99 units. The maximum amount of credit that the owner could take would be $5,000 for each of 99 units, or $495,000 total for the 99 units combined.

In the second year, the one remaining unit is occupied by the LIHTC-eligible tenant. As stated previously, the pro-rated amount of credit per unit is $5,000. Since the owner did not lease the unit during the first year of the credit period, each year he or she would be eligible to claim only 2/3 of the $5,000 pro-rated allocation, or $3,333.33. That amount, $3,333.33 could be claimed each year for 14 years. Over the 14 years, the amount of credit claimed would be $46,666.67, rather than the $50,000 that would have been eligible if the 2/3 rule had not been triggered due to failure to lease the unit during the first credit year.

If an owner decides to take the tax credit for a property in the initial year when, for example, only 80% of the units are rented to tax credit eligible tenants, the maximum qualified basis for the entire credit period would be 80% with the remaining 20% eligible for two-thirds credit if later rented to eligible tenants.

Part 465 When Compliance Period Begins

Compliance begins prior to initial lease-up activity. A representative from the owner <u>and</u> its property management company are strongly encouraged to attend LIHTC compliance training prior to the placed-in-service date of the first building completed in the project. For more information regarding the compliance period, see Part 230 (Compliance Period).

For a related discussion, see Part 1080 (Interfacing LIHTC with other Government Housing Programs).